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In the

Supreme Court of the United States

OCTOBER TERM, 1950

No. .....

FRANK NICK,

Petitioner,

v.

JOHN B. DUNLAP, ACTING COLLECTOR OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Frank Nick prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above entitled case on December 21, 1950, affirming the judgment of the United States District Court for the Northern District of Texas, Dallas Division.

OPINIONS BELOW

The opinion of the District Court (R. 40-41) is not reported. The opinion of the Court of Appeals (R. 50-51) is reported in *185 F. 2d 674*.

JURISDICTION

The judgment of the Court of Appeals was entered on December 21, 1950. (R. 52.) The jurisdiction of this Court is invoked under the provisions of *28 U. S. C. 1254*.

QUESTIONS PRESENTED

In 1947 the taxpayer (Petitioner) discovered and voluntarily disclosed to the Bureau of Internal Revenue additional 1945 income which had not been reported in his income tax return for that year. The Commissioner of Internal Revenue assessed a substantial 1945 income tax deficiency against this taxpayer, adding 50% of the total amount thereof as a civil penalty, along with interest. All of this tax, including penalty and interest, was promptly paid. The taxpayer in no way contested the propriety of the penalty addition to the tax. For the year 1947 taxpayer suffered a severe net operating loss in his business which when carried back as an additional deduction materially reduced his entire 1945 income tax liability. Taxpayer claimed and was allowed a refund of the 1945 tax deficiency overpaid but the Commissioner refused to refund any part of the 1945 overpayment collected as a penalty, though it was and is proportionately claimed.

The question presented is: should the taxpayer be refunded the proportionate part of a civil, *ad valorem* penalty payment when the total amount of the deficiency by which such penalty is measured (50% of the deficiency) is reduced by recognition of an additional income tax deduction provided by law. Put another way, is the Commissioner authorized by law to retain the entire amount of

a civil, *ad valorem* penalty collection when the amount of tax deficiency of which the penalty is a percentage is subsequently reduced.

STATUTES INVOLVED

The pertinent statutory provisions appear in the Appendix, *infra* p. 25.

STATEMENT

The facts in this case were not in dispute, being largely stipulated. (R. 13-17.) Trial was before the Court without a jury. Briefly the facts are as follows:

The taxpayer (Petitioner), reporting on a calendar year basis for the year 1945, timely filed an income tax return on the basis of which he paid a tax of $1,219.01. The Court found that subsequently the taxpayer voluntarily disclosed to the Bureau of Internal Revenue that he had additional income in 1945 which was not reflected in his original 1945 tax return. (R. 40.) Thereupon, the Commissioner of Internal Revenue investigated taxpayer's 1945 income and on the basis of such investigation made the following assessment against the plaintiff on August 25, 1947:

Tax	$17,450.56
Penalty — 50% of tax	8,725.28
Interest on tax 3-15-46 to 8-25-47	1,511.92

The taxpayer did not petition The Tax Court of the United States for a redetermination of the matter nor did he contest the determination in any other manner. The above amounts, plus additional interest of $127.45, totaling $27,815.21 were paid October 20, 1947.

For the year 1947, the taxpayer sustained an almost overwhelming net operating loss in the conduct of his business. A claim was duly and timely filed with the Collector of Internal Revenue for refund of 1945 tax and penalty overpayment (R. 17-27) based on the carry-back of the said 1947 loss as a deduction for 1945 as provided by law. This net operating loss deduction entitled the taxpayer to a recomputation of his 1945 tax liability and a refund of any resultant overpayment. The recomputation showed that the taxpayer's entire 1945 tax was only $5,177.64 (without penalty or interest) whereas he had paid tax of $18,669.57 (without penalty or interest). The Collector promptly refunded the difference, $13,491.93, but refused to refund any money previously collected as penalty ($8,725.28) or interest ($1,511.92). (R. 16.)

The pleadings in this case originally sought a refund of a proportionate part of the assessed interest, the tax being reduced by the carry-back deduction, but this was waived at the time of trial. (R. 37-38.) With respect to the penalty portion of the assessment the taxpayer contended that, inasmuch as the amount of the penalty can be measured only by (50 per centum of) the total amount of the deficiency [Sec. 293(b) I. R. C.], when the tax *deficiency* was reduced to $3,958.63 the Collector could lawfully keep no more than one-half of that amount, or $1,979.31, as penalty. Therefore, inasmuch as the Collector had collected and had the full use of $8,725.28 as penalty, taxpayer was entitled to a refund of the difference, that being $6,745.97. Another issue as to the correct amount of the 1945 net operating loss deduction was waived at trial time, the amount

as calculated by the Respondent being accepted. (R. 37.) Therefore, the only issue before the Court concerned the proportionate refund of the penalty to the extent that the total amount of the 1945 deficiency was reduced by the lawful carry-back deduction and resulting recomputation. Respondent's position on this item seemed to be that the penalty assessed August 25, 1947, was the correct amount even though Petitioner was to be entitled to an additional 1945 deduction resulting in a recomputation substantially reducing his 1945 tax. Hence, said Respondent, the taxpayer was not entitled to a refund of any portion of the penalty, notwithstanding that the penalty cannot, under the plain language of the controlling statute, exceed 50% of the total amount of the *deficiency*. Presented in summary form, the issue is as follows:

Amount of additional 1945 principal tax determined to be due by Commissioner and assessed on August 25, 1947	$17,450.56
50% of above amount as penalty	8,725.28
Amount of taxpayer's 1945 deficiency after application of 1947 net operating loss deduction and recomputation	$ 3,958.63
50% (of above) deficiency as penalty	1,979.31
Penalty assessed August 25, 1947 and paid October 20, 1947	$ 8,725.28
Less penalty applicable after carry-back deduction — 50% of the $3,958.63 deficiency	1,979.31
Amount claimed to be refundable by taxpayer and which Respondent refused to refund	$ 6,745.97

The District Court gave its oral opinion (R. 40) holding for defendant.

On appeal by the taxpayer, the Court of Appeals affirmed the judgment of the District Court. (R. 50-51.)

REASONS FOR THE ALLOWANCE OF THE WRIT

1. This case presents an extremely important question of federal law arising under the Internal Revenue laws. The question has not been decided by this Court. The problem arises frequently in the administration of the tax laws of the government and will continue to arise for many years to come unless settled by this Court. There are no reported cases on the point involved except the decision of the Court of Appeals in this case which is a two-sentence per curiam affirmance of the unreported District Court judgment. The issue involved arises every time a penalty is asserted against a taxpayer if subsequently, in a later year, the taxpayer suffers a net operating loss by virtue of which he becomes entitled to a net operating loss deduction which may be carried back to the year in which the penalty was asserted. While this case involves income taxes the identical problem is encountered in connection with the Excess Profits Tax provisions of the Internal Revenue laws.

Petitioner does not have the command of a field staff covering the United States and therefore cannot submit detailed and exact figures of the number of cases wherein this same question is involved. However, in the Government's petition for writ of certiorari in *Manning v. Seeley Tube & Box Company, 338 U. S. 561, 70 S. Ct. 386, 94 L.*

Ed. 314, it was represented that there were "literally thousands" of cases involving the question of whether to refund "interest" collected on a deficiency when the taxpayer's tax liability was reduced by a net operating loss deduction. Also it was stated the Treasury anticipated not less than 15,000 cases yearly which involved the "interest" problem. It is not known what percentage of these cases also involve a "penalty" item but it can be expected that the number is substantial in view of the fact that the Internal Revenue Code provides for numerous *ad valorem* penalties. There is a 5% penalty for negligence, a 5% to 25% penalty for failure to file a return on time, known as a delinquency penalty, and a 50% penalty for civil fraud. Penalties are also provided for failure to file or make appropriate payments on a declaration of estimated tax and for substantially underestimating the amount of tax due or to become due. Regardless of the nature of the civil, *ad valorem* or percentage penalty asserted the same problem is presented. In this case only the 50% penalty is involved. That such liability is designated a civil fraud penalty should and does not in any way color the point of law considered. Sinners as well as saints have been said to have equal rights before the law. The legal proposition would be the same though involving a delinquency or negligence or other percentage penalty. If the Commissioner is trying to retain an exaction not authorized by law, he should be made to return it.

2. After the decision of this Court in the *Seeley* case the Bureau of Internal Revenue issued its interpretation in

the form of a General Counsel Memorandum[1] which conformed the Bureau's written policy to the holding in the *Seeley* case relative to refund of "interest" in net operating loss carry-back deduction situations. However, the Bureau did not confine itself within the borders of the *Seeley* decision. Rather, it extended the holding by stating that it was also applicable to refunds of penalty. Now the Bureau holds that there is no distinction between "interest" and "penalty" for refund purposes in carry-back situations. Thus the Bureau has very effectively enlarged the scope of a Supreme Court decision and applies the same treatment to a situation which was not the subject of the decision in the *Seeley* case and which should not be subjected to the same treatment. This taxpayer is only one out of thousands who have no hope of securing a voluntary refund from the Treasury in situations such as presented here unless this Court grants the requested writ and settles the question.

3. Prior to *Seeley* the Bureau of Internal Revenue had made refunds of penalties under circumstances such as presented here. Its policy in this regard, however, seems not to have been consistent. Since the *Seeley* case the Bureau has concluded that such penalties are not refundable and that those refunded were in error. It is understood by Petitioner that the Bureau is now in the process of demanding repayment of such penalty refunds and in some cases has instituted suit against taxpayers to recoup such refunds. Review of the question herein presented would settle the matter once and for all and would place the

[1] No. 26,455, 1950-1 Cumulative Bulletin 118, appendix, *infra pp. 26-27.*

government, as well as the taxpayer, in the position of being able to pursue a charted course. Even if the decision of the Court of Appeals is considered to be a correct interpretation of the law and application of the *Seeley* case, it is of very little usefulness in view of the fact that the decision does not reveal what question was presented.

CONCLUSION

For the reasons stated, this petition for writ of certiorari should be granted.

Respectfully submitted,

.....

S. L. MAYO,

.....

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625 Republic Bank Building,
Dallas, Texas,
Counsel for Petitioner.

March, 1951.

In the

Supreme Court of the United States

OCTOBER TERM, 1950

No. .....

FRANK NICK,

Petitioner,

v.

JOHN B. DUNLAP, ACTING COLLECTOR OF INTERNAL REVENUE,

Respondent.

SUPPORTING BRIEF

OPINIONS BELOW

The Court of Appeals opinion is reported in *185 F. 2d 674*. The District Court opinion (R. 40-41) is not reported.

JURISDICTION

The judgment of the Court of Appeals was entered December 21, 1950. (R. 52.) Jurisdiction of this Court is invoked under the provisions of *28 U. S. C. 1254*.

STATEMENT OF THE CASE

In the interest of brevity the facts of the case will not be repeated here. Reference is made to the Statement in the Petition, supra pp. 3-4, which is sufficient for the purpose of this brief.

SPECIFICATION OF ERRORS

The Court of Appeals erred in affirming the judgment of the District Court and in so doing failed to hold that where a taxpayer sustained a net operating loss in 1947 and such loss was carried back to 1945 as a deduction and the taxpayer's 1945 income tax liability was recomputed, being reduced by such carry-back deduction, it was erroneous for the Collector of Internal Revenue to refund only that portion of the principal tax abated by the carry-back deduction and fail and refuse to refund to the taxpayer that portion of a 50 per cent penalty collected for the year 1945, which was proportionately abated by reason of such carry-back deduction and recomputation.

SUMMARY OF ARGUMENT

The case of *Manning v. Seeley Tube & Box Company, 338 U. S. 561, 70 S. Ct. 386, 94 L. Ed. 314,* did not involve a matter of a refund of a penalty and is neither controlling nor applicable to the facts here presented. There are both statutory and generally recognized distinctions between "interest" and "penalty." The Respondent's expansion of the *Seeley* holding to cases involving penalty items is unwarranted. The judgments of the courts below do violence to a plain and unambiguous statutory provision that the carry-back *deduction* operates and is fully effective the same as any other Sec. 23 deduction and *shall be allowed* in computing net income. The law does not look with favor upon the exaction or retention of civil penalties and rules of statutory construction require interpretation in favor of the one from whom such penalty has been exacted. Al-

though the Internal Revenue Code permits the assessment and collection of a penalty of 50% of the deficiency in tax, the holdings of the trial and appellate courts sanction the collection and retention of a penalty in excess of 200% of the deficiency in tax.

ARGUMENT

POINT 1

The Seeley case holding is not applicable to refunds of penalties.

The *Seeley* case dealt with the refund of *interest* collected on a deficiency when that deficiency was reduced by the operation of the carry-back provisions of the Code. Briefly the facts there were: The taxpayer filed a 1941 return on a fiscal year basis and paid the tax shown to be due. In 1943 the Commissioner assessed additional taxes for the year 1941 together with interest at six per centum per annum from the time the 1941 tax was due to the date of the assessment. Before this assessment was paid, the taxpayer sustained a 1943 net operating loss the deduction arising from which, when carried back to the year 1941, completely eliminated the 1941 tax paid and the "deficiency" assessed. The taxpayer filed a claim for abatement of the "deficiency assessment" and interest. The Commissioner abated the "deficiency" but refused to refund all of the original tax which had been paid, retaining therefrom an amount equal to the interest which had been assessed on the "deficiency." In a suit for a refund of this withheld "interest" the District Court held for the govern-

ment. The United States Court of Appeals for the Third Circuit reversed and held for the taxpayer, *172 F. 2d 77*. This Court reversed the judgment of the Court of Appeals and affirmed the District Court judgment.

This Court quite properly held that the taxpayer was under a positive obligation to pay his tax when due and held for the government on the theory that the government was entitled to be compensated at the statutory rate of 6 per cent per annum during the period that the taxpayer had the money and the government had been deprived of the *use* of the money.

The Code is replete with provisions relating to interest. These provide when the Commissioner shall collect interest and when he shall refund it. The taxpayer must pay interest when he files a return and fails to pay the tax shown thereon. Int. Rev. Code Sec. 294(a)(1). If the Commissioner authorizes an extension of time within which to file a return the taxpayer must pay interest on the amount of tax due from the time originally due until paid. Int. Rev. Code Secs. 56(c)(1), 295. If a deficiency is assessed and its payment is delayed the taxpayer must pay interest on the deficiency from the date of notice and demand until it is paid. Int. Rev. Code Sec. 296. Interest in the case of jeopardy assessments is provided for in Sec. 297. A provision for interest is made relating to bankruptcy and receivership matters. Int. Rev. Code Sec. 298.The government is obliged to pay interest on credits and refunds. Int. Rev. Code Sec. 3771. Specific provision is made for the payment of interest on refunds when a carry-back deduction is involved. Int. Rev. Code Sec. 3771(e).

Interest is for the purpose of compensating the person who has been deprived of the use of money and the amount of interest is measured by the length of time such person has been deprived of the use of the money owed. The *time* factor is not involved in the measurement of a civil penalty under the Internal Revenue Code. The penalty has only one measurement. It is, in this case, 50% of the deficiency in tax. The taxpayer's default may be one day or ten years but the amount of the penalty is the same. Inasmuch as the Petitioner did not contest the validity of the penalty assessment, he cannot escape its effect. His quarrel is not with having to pay a penalty but rather the amount of measure of the penalty as calculated by the Commissioner. Unlike interest on a deficiency, a penalty is not *due* until the Commissioner makes the determination that the taxpayer should pay a penalty. Interest is due by operation of statute and the Commissioner has no authority to waive its collection. When the Commissioner determined that the Petitioner should be required to pay a 50% penalty the latter paid it promptly. (R. 14.) Not only did he pay the penalty but he paid the additional tax and full interest thereon to compensate the government for having had the use of the funds from the time the tax was due until it was paid. Petitioner made a voluntary disclosure of his additional 1945 unreported income and thereby saved the government the time and expense normally required to ferret out cases of taxpayers with unreported income.

Petitioner finds no quarrel with the Commissioner's contention that since *Seeley* requires prompt payment of taxes

a taxpayer should not be relieved of the obligation to report his taxes honestly. But this is really begging the question. The point involved is the lawful *measure* of the penalty required in cases where the taxpayer does not honestly report his taxable income. Is it 50% of the additional tax due without regard to *all* the taxpayer's deductions or is the taxpayer entitled to *all* the deductions the law allows in determining the *deficiency* and the resulting penalty amount? The Respondent here would have the Court deprive the taxpayer of the full effect of a *deduction* when a matter of a refund of penalty is involved. Sec. 293(b) of the Code is the statutory provision which authorizes the Commissioner to impose a 50% penalty for fraud. It provides:

> "Fraud. — If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid * * *."

This section does not contain any provision relating to the treatment of a penalty in the event of a carry-back deduction. The preceding Code section, Sec. 292(c), relating to interest on deficiencies, and Sec. 3771(e) relating to interest on refunds, specifically provide what the treatment of interest shall be in the event of a carry-back deduction. The provisions of those sections as well as others clearly evidence Congress' intention that the government is to be compensated for the taxpayer having had the use of tax money due the government. No similar provision is to be found in the Code relating to treatment or restriction of

penalties and their refund when due to carry-back deductions.

POINT 2

The Commissioner's enlargement of the holding in Seeley to be applicable to refunds of penalties is unwarranted.

The Revenue Act of 1918,[1] contained a provision for a net loss deduction with a carry-back provision. In 1923 the Bureau by administrative interpretation in the form of a Law Opinion[2] held that the carry-back deduction to a year in which a penalty had been invoked had the effect of eliminating the penalty if the deficiency was reduced to zero. It stated:

> "(1) Where a return contains a fraudulent understatement of tax and there is therefore a deficiency in the tax, but the deficiency is wiped out by applying a deduction allowable under section 204 [*net loss*], the ad valorem fraud penalty provided in section 250 (b) [*50 per centum of the amount of the deficiency*] is not applicable, since upon the redetermination under section 204 there is no deficiency within the meaning of section 250(b)." (Bracketed material added for explanation.)
>
> * * * * *
>
> "Clearly a penalty which under the statute must be measured by the amount of the tax is excessive in amount if for any reason the tax is, under legal authority, reduced; in other words, where, after the penalty has been calculated on the greater amount of tax, the basis on which a percentage penalty rests is reduced, the penalty is excessive unless it be proportionately reduced, and since the amount of such re-

[1] 40 Stat. L. 1057-96, C. 18.

[2] Law Opinion 1115, II-2 Cumulative Bulletin 221.

duction of penalty measures the excessive amount assessed or collected, and since the fraud penalty is for the purposes of the sections under consideration made a part of the tax, there is no escape from the conclusion that the excess may be lawfully credited or refunded under the provisions of section 252."

After *Seeley* the Bureau revoked this interpertation[3] and said that the *Seeley* case was authority for holding that penalties were not affected by carry-back deductions. We believe that this Court's decision in *Seeley* is sound but consider it unfortunate that the Court cast aside the Law Opinion on the grounds not that it lacked reason and logic but that it had not been repeated in 25 years. There is good cause that the interpretation was not repeated. The carry-back deduction provision was eliminated from the internal revenue laws during the period from January 1, 1920 to January 1, 1941[4] — a period of 21 years. There was little need, if any, for repeating interpretations relating to matters not within the internal revenue laws during that period.

POINT 3

In failing to refund the taxpayer the proportionate part of the penalty abated by the carry-back deduction the Commissioner has denied him a deduction allowed by law.

Section 23 of the Code provides for numerous deductions allowed the taxpayer. These deductions are subtracted from gross income to arrive at taxable net income before

[3] General Counsel Memorandum No. 26,455, 1950-1 Cumulative Bulletin 118.

[4] Revenue Act of 1942 added carry-backs to Code to be effective for the taxable year beginning after December 31, 1940.

the formula is applied to determine the amount of the tax or deficiency. One of these deductions is the net operating loss deduction. Sec. 23(s). In arriving at the taxpayer's deficiency in tax it is obligatory upon the Commissioner to allow the taxpayer all deductions authorized by law. Here the Commissioner seems to say that the operating loss deduction is to be given limited effect in that although the deficiency is reduced the penalty is not affected notwithstanding the fact that the penalty can be measured only by the amount of the deficiency.

Surely there can be only one deficiency in tax for any one given year. "Deficiency" is defined in Section 271 of the Code. Reduced to its applicable meaning here and as pointedly stated by this Court in *Seeley*, it is "the difference between the tax imposed by law and the tax shown upon the return." To say that *the tax imposed by law* is one amount arrived at without regard to *all* allowable deductions is to contradict the definition and render it meaningless. There is very real difference in a "deficiency assessment" and the "deficiency." The Commissioner may make many deficiency assessments for any given year but there can be only one *real deficiency* and that is the difference between the amount of tax imposed by law and the amount shown upon the return. It is elementary that when the Commissioner's assessment is reduced by operation of law, by the Courts or by reason of any other legal grounds, the penalty assessed by the Commissioner will be correspondingly reduced. In *Duffin v. Lucas, 55 F. 2d 786 (C. C. A. 6, 1932), cert. den. 287 U. S. 611*, the Court at page 789 stated:

> "Of course, if the deficiency assessment is necessarily reduced by eliminating items of income which were a part of its basis, *the penalty will lessen correspondingly.*" (Emphasis added.)

The deficiency assessment may be reduced by "eliminating items of income" or it may be lessened by allowing additional lawful deductions. The reason for reduction of the deficiency is unimportant. The important thing is that if (for any reason) the deficiency assessment is reduced, any penalty assessment measured by the amount of the deficiency must be reduced accordingly. An example of the full operation of the carry-back and carry-over deduction provisions will serve to illustrate how the holding of the courts below will require the Commissioner to give the same deduction different treatment in differently related tax years, without statutory distinction to be found. Assume the taxpayer had a 1947 net operating loss giving rise to a $30,000.00 deduction, the carry-back of $10,000.00 of which to 1945 reduces to zero the tax for that year (original and/or deficiency). Assume further that another $10,000.00 of the 1947 loss deduction was carried back to 1946 (through 1945) reducing the 1946 tax (original and/or deficiency) to zero. This leaves $10,000.00 which may be carried over into 1948 as a deduction. Furthermore, suppose the taxpayer, with intent to evade tax, underreported his 1948 income so as to subject him to a 50 per centum fraud penalty on the total amount of any 1948 deficiency found. Now, in 1949, the Commissioner determines the taxpayer owes $5,000.00 additional taxes

for 1948 except for the carry-over deduction. He finds that when the carry-over deduction is taken into consideration, the taxpayer has no deficiency in tax at all for 1948. In this situation the Commissioner, under Sec. 23(s) I. R. C., shall and does give the taxpayer the full benefit of the operating loss deduction. This is true notwithstanding the evil intent, the fraud if you please, is precisely as wrong in the later year as it could ever have been with respect to a prior year. The fact remains that, in the assumed case, there being no 1948 deficiency, the Commissioner could not legally assess a fraud penalty — because the fraud penalty can by law be only 50 per centum of the deficiency (zero in the supposed case). No deficiency — no penalty. Less deficiency — less penalty. In the assumed case, the taxpayer received the full benefit of the deduction — and so he should for the prior years inasmuch as it is the same Sec. 23(s) I. R. C. deduction applied in different years according to Sec. 122 I. R. C. To treat it otherwise is to say that the taxpayer is to be given full benefit of the deduction except in prior years where fraud was involved. Search as one may, he will find no statutory authority which authorizes the Commissioner to treat a Sec. 23(s) I. R. C. deduction in such manner. If it is a deduction, it is entitled to be given that status. To treat it as a *credit* robs it of its importance and is directly contrary to the statutory provisions which define it as a *deduction.* The only basis on which the Collector can assert his inconsistent position is that in this case "the assessment was

made" *before* it was known whether or that the taxpayer was entitled to an additional deduction in computing his 1945 income tax. Collection of taxes, and penalties it would seem, must be bottomed on liabilities established by law — not *when* assessment procedure happens to mesh into gear. Invocation of degrees of harsh penalties should not rest upon the point-of-time circumstance of *when* an assessment is made.

POINT 4

Rules of statutory construction require refund of penalty in the absence of clear and unambiguous statutory provisions to the contrary.

The Respondent cannot point to any statutory provision which clearly authorizes retention of the penalty collected in carry-back deduction cases. Neither can the Petitioner invoke the aid of a clear statutory provision which in so many words requires the unconditional refund of the penalty sought. In the absence of such provision resort to rules of statutory construction is appropriate. Citation of authorities is not necessary for the proposition that the law abhors fines, penalties and forfeitures of a civil nature. In the absence of clear statutory provision authorizing the Commissioner to retain the penalty the statutes should be construed in favor of the taxpayer. In *Hatfried Inc. v. Commissioner, 162 F. 2d 628 (C. C. A. 3, 1947)*, the court observed:

> "Further, it is well-settled that in the application of penalties 'all questions in doubt must be resolved in

> favor of those from whom the penalty is sought' Crawford, Statutory Construction, Section 240, page 462."

As early as 1879 this Court in *Elliott v. East Pennsylvania R. Co., 99 U. S. 573, 25 L. Ed. 292,* expressed the recognized rule:

> "Penalties are never extended by implication. They must be expressly imposed or they cannot be enforced."

Furthermore, the net operating loss provision is remedial in nature and was intended to give the taxpayer a five-year spread of taxes so that in the event of an operating loss in one year its benefit could be extended to years of profits. Being remedial in character rules of statutory construction require liberal interpretation in favor of the taxpayer to give the results intended. *Bonwit Teller & Co. v. United States, 283 U. S. 258; Kimbrell's Home Furnishings, Inc. v. Commissioner, 159 F. 2d 608 (C. C. A. 4, 1947).*

CONCLUSION

The question presented involves an important matter in the administration and application of the revenue laws which should be settled now by this Court. To grant a writ on this question now will result in approval of the course being pursued by the Respondent or disapproval of such course before irreparable harm is done to taxpayers generally. For these reasons and the further reason that the decision of the Court of Appeals is in error, petitioner

prays that certiorari be granted and the judgment of the Court of Appeals reversed.

Respectfully submitted,

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.....

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Counsel for Petitioner.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(s) *Net Operating Loss Deduction.* — For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

SEC. 122. NET OPERATING LOSS DEDUCTION.

(a) *Definition of Net Operating Loss.* — As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions and limitations provided in subsection (d).

(b) *Amount of Carry-back and Carry-over.* — (1) *Net operating loss carry-back.* — If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

* * * * *

SEC. 271. DEFINITION OF DEFICIENCY.

(a) *In General.* — As used in this chapter in respect of a tax imposed by this chapter, "deficiency" means the amount by which the tax imposed by this chapter exceeds the excess of —

(1) the sum of (A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over —

(2) the amount of rebates, as defined in subsection (b)(2) made.

SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

(a)—

(b) *Fraud.* — If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612(d)(2).

SECTION 29.322-3: Claims for refund by taxpayers.

1950-12-13370
G. C. M. 26455

Reconsideration has been given to L. O. 1115 [C. B. II-2, 221 (1923)] in the light of the decision in *Manning v. Seeley Tube & Box Co.* (338 U. S. 561, Ct. D. 1729, page 113, this Bulletin).

L. O. 1115 holds:

(1) Where a return contains a fraudulent understatement of tax and there is therefore a deficiency in the tax, but the deficiency is wiped out by applying the deduction allowable under section 204 of the Revenue Act of 1918, the ad valorem fraud penalty provided in section 250(b) of said Act is not applicable since upon the redetermination under section 204 of the Act there is no deficiency within the meaning of section 250(b); (2) where a tax is assessed and collected, together with the 5 percent penalty and interest at the rate of 1 per centum per month, provided

in section 250(e) for failure to pay within 10 days after notice and demand by the collector, and by reason of a redetermination as provided in section 204 the tax is reduced and a portion refunded, so much of the penalty and interest made a part of the tax by section 250(c) as is applicable to the amount of the tax refunded may be credited or refunded as excessive, as provided in section 252; * * *

In the Seeley Tube & Box Co. case, *supra*, the Supreme Court of the United States held that where a deficiency and interest have been validly assessed under any applicable statutory procedure, a subsequent carry-back of a net operating loss which results in the abatement of the deficiency does not abate the interest previously assessed on that deficiency. In concluding that the Bureau was entitled to interest, the Supreme Court necessarily concluded that there was a real deficiency existing prior to the occurrence of the carry-back loss since the right to interest is dependent upon the existence of a deficiency. Consequently, it appears to follow that for purposes of the penalties imposed under sections 291 and 293 of the Code, a real deficiency must likewise be considered to exist. If an amount representing interest or penalties has been collected, it is believed that, regardless of a subsequent carry-back, the Bureau is entitled to retain such amount. The statutory pattern requiring prompt payment of taxes was the foundation of the opinion in the Seeley Tube & Box Co. case. The requirement of prompt filing of returns is equally a statutory duty of a taxpayer. The carry-back provisions of the Code do not modify that duty. As pointed out by the Supreme Court, the Senate Committee on Finance made it clear that a taxpayer who is entitled to carry back a net operating loss must file his return and pay his tax without regard to the deduction. (See Senate Report No. 1631, pages 123-124, C. B. 1942-2, 504, 596-597.)

In view of the foregoing, it is the opinion of this office that interest and penalties assessed and collected in connection with a Federal income tax liability should not be credited or refunded even though such tax liability is reduced or eliminated by net operating loss carry-backs.

Accordingly, L. O. 1115 [C. B. II-2, 221 (1923)] is hereby revoked.

CHARLES OLIPHANT,
Chief Counsel, Bureau of Internal Revenue.

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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 626

FRANK NICK, PETITIONER

v.

JOHN B. DUNLAP, Acting Collector of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The oral opinion of the District Court (R. 40-41) is not reported. The *per curiam* opinion of the Court of Appeals (R. 49) is reported at 185 F. 2d 674.

JURISDICTION

The judgment of the Court of Appeals was entered on December 21, 1950. (R. 50.) The petition for a writ of certiorari was filed on March 21,

1951. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Taxpayer underpaid his 1945 income taxes. The Commissioner determined that the underpayment was due to fraud and assessed a deficiency in tax, together with the fraud penalty provided by Section 293 (b) of the Internal Revenue Code. In a later year, taxpayer incurred a net operating loss which, when carried back and deducted in 1945, resulted in a refund of part of the amount which he had paid as deficiency taxes for 1945.

The question presented is whether the Court of Appeals erred in sustaining the District Court's determination that the carry-back of the net operating loss did not entitle taxpayer to a corresponding refund of the fraud penalty.

STATUTES INVOLVED

These will be found in the Appendix, *infra,* pp. 9-12.

STATEMENT

The material facts as stipulated (R. 13-29) and as found by the District Court in its oral opinion (R. 40-41) are as follows:

Taxpayer timely filed his 1945 income tax return reporting taxable net income of $5,393.15 and a tax thereon of $1,219.01. In fact, however, taxpayer had more taxable income than reported in his return and at a later date he so notified the Commissioner of Internal Revenue. After investigation,

the Commissioner determined that taxpayer had omitted from his 1945 return $31,885.63 of net taxable income and that the omission had been due to fraud with intent to evade tax. Pursuant to this determination, the following additional assessments were made against taxpayer for 1945:

Deficiency in tax	$17,450.56
Addition to tax for fraud (50 per cent of deficiency)	8,725.28
Interest on deficiency	1,511.92

These amounts have been paid and, except as affected by the 1947 loss carry-back, are not in dispute (R. 14, 40.)

For 1947, taxpayer's income tax return disclosed a net operating loss of $26,616.94. Taxpayer filed an appropriate refund claim asking to have the loss carried back and allowed as a deduction in 1945, with a consequent reduction of tax liability for the latter year. The refund claim was in the amount of $23,543.47, and included not only that part of 1945 taxes which would be refundable as a result of allowing the net operating loss as a deduction, but also corresponding portions of the fraud penalty and deficiency interest which had been assessed for 1945. (R. 14, 17-20.)

The Commissioner allowed the claim in part and refunded to taxpayer $13,491.93, with interest. The balance of the refund claim was disallowed, the Commissioner having concluded that no part of the fraud penalty or the deficiency interest was

refundable; and, further, that taxpayer had overstated his 1947 operating loss. (R. 15-16.)

Taxpayer then brought the present action, challenging each of the foregoing adjustments. However, after the trial began, he abandoned his contest of the Commissioner's action in reducing the 1947 net operating loss and also conceded that the recent decision by this Court in *Manning* v. *Seeley Tube & Box Co.*, 338 U.S. 561, foreclosed any right to recover deficiency interest. (R. 37-38.)

The only issue left for determination was whether the taxpayer was entitled to a refund of a portion of the 1945 fraud penalty. The District Court ruled that he was not, and directed that judgment be entered for the Collector accordingly. The Court of Appeals, as we have said, affirmed *per curiam* (R. 49) on the authority of the *Seeley Tube* decision.

ARGUMENT

There is no occasion for further review of this case. Certainly there is not shown, nor can there be found, any conflict among the Courts of Appeals in respect of the problem concerned. Moreover, we maintain that the Fifth Circuit was entirely correct in its conclusion (R. 49) that this Court's decision in *Manning* v. *Seeley Tube & Box Co.*, 338 U. S. 561, is controlling here. It is manifestly immaterial that the Bureau of Internal Revenue may have incorrectly treated the matter prior to final

determination in *Manning* v. *Seeley Tube & Box Co.* (Pet. 8-9, Br. 17-18.)

We make no assertion, of course, that the *Seeley Tube* case is directly authoritative. What we submit is that, somewhat comparable to this Court's reliance in *Commissioner* v. *Connelly*, 338 U. S. 258, upon its precursor decision in *Mitchell* v. *Cohen*, 333 U. S. 411, the precise question which was before the two courts below in this instance has been answered in favor of the government by the rationale of *Seeley Tube*. Indeed, in our judgment, the present proposition is implicit in the *Seeley Tube* decision.

It will be recalled that in *Seeley Tube, supra*, the taxpayer filed its returns for the fiscal period ending in 1941 and paid the reported taxes. In 1943 the Commissioner assessed additional taxes for 1941, together with deficiency interest. These assessments were still unpaid when taxpayer filed its 1943 corporate income tax return disclosing a substantial net operating loss which, when carried back pursuant to Section 122 of the Internal Revenue Code (Appendix, *infra*, p. 10), was sufficient to offset all taxable net income for 1941. Accordingly, Seeley filed claims for refund of 1941 taxes already paid and for abatement of the outstanding deficiency assessments for that year. The Commissioner recognized taxpayer's right to the asserted loss carry-back and abated the tax deficiency, but declined to abate the interest which had been assessed on the deficiency. Collection of the defi-

ciency and interest thereon having been effected, taxpayer sued for its recovery. When, in due course,[1] the case reached this Court, it reversed the judgment below, and held that, "The subsequent cancellation of the duty to pay this assessed deficiency does not cancel in like manner the duty to pay the interest on that deficiency." 338 U. S. at 565. In so holding, the Court reasoned that the enactment of the carry-back provisions in 1942 did not alter the basic obligation of taxpayers to pay promptly taxes which were properly due at the close of the tax year; and that, while for certain purposes the carry-back resulted in a *de novo* determination of the tax, it did not operate retrospectively to discharge the statutory increments which had accrued by reason of a taxpayer's failure to pay his full tax on time.

Congress has required the filing of honest tax returns as well as timely ones. The purpose of the 50 per cent fraud penalty is to induce the filing of honest tax returns, just as the purpose of the interest requirement is to induce prompt payment. In this case, the fraud penalty became due when the false return for 1941 was filed. It was only because of the loss in a subsequent year that part of the underlying tax deficiency was refunded. The core of the petitioner's argument is that the fraud pen-

[1] See *Seeley Tube & Box Co.* v. *Manning*, 76 F. Supp. 937 (D. N. J.), upholding the Commissioner; reversed on appeal, 172 F. 2d 77 (C.A. 3d), certiorari granted, 337 U. S. 955.

alty can only be computed upon the basis of the 1945 tax deficiency as thus reduced by the carryback of his 1947 operating loss. But it is clear from the rationale of the *Seeley* decision that a loss in a subsequent year does not wipe out the fraud liability [2] of the earlier year, any more than it cancels the duty to pay interest on the tax deficiency of the earlier year.[3]

---

[2] It is of course immaterial that in the instant case there was a voluntary disclosure of the taxpayer's understatement of income for 1945, just as the actual cost, if any, to the Government arising out of the understatement is immaterial. *Helvering* v. *Mitchell*, 303 U.S. 391.

[3] The *Seeley Tube* decision by this Court states in pertinent part (338 U. S. 561, 566, 567-568):

"It is apparent from an inspection of the Code that Congress intended the United States to have the use of the money *lawfully* due when it became due. *Several sections of the Code prescribe penalties and additions to the tax for negligence and fraud.* A taxpayer who files a timely return but does not pay the tax on time must pay interest on the [lawful] tax until payment.

* * * * *

Although it is true that for many purposes the carryback is equivalent to a *de novo* determination of the tax, our conclusion that this section does not retroactively alter the duty of a taxpayer to pay his *full* tax promptly is amply supported by § 3771(e) of the Code. * * *

To sustain respondent's contention would be to place a premium on failure to conform *diligently* with the law. * * *" (Italics supplied.)

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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APRIL, 1951.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(s) [As added by Sec. 211 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 53. TIME AND PLACE FOR FILING RETURNS.

(a) *Time for Filing.*—

(1) *General Rule.*—Returns made on the basis of the calendar year shall be made on or before the 15th day of March following the close of the calendar year. Returns made on the basis of a fiscal year shall be made on or before the 15th day of the third month following the close of the fiscal year.

* * * * *

(26 U.S.C. 1946 ed., Sec. 53.)

SEC. 56. PAYMENT OF TAX.

(a) *Time of Payment.*—The total amount of tax imposed by this chapter shall be paid on the fifteenth day of March following the

close of the calendar year, or, if the return should be made on the basis of a fiscal year, then on the fifteenth day of the third month following the close of the fiscal year.

* * * * *

(26 U.S.C. 1946 ed., Sec. 56.)

SEC. 122. [As added by Sec. 211 (b) of the Revenue Act of 1939, *supra*]. NET OPERATING LOSS DEDUCTION.

(a) [as amended by Sec. 105(e), Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [As amended by Sec. 153 (a) of the Revenue Act of 1942, *supra*.] *Amount of Carry-Back and Carry-Over.*—

(1) *Net Operating Loss Carry-Back.*—If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations pro-

vided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

* * * * *

(26 U.S.C. 1946 ed., Sec. 122.)

SEC. 292. INTEREST ON DEFICIENCIES.

(a) [As amended by Sec. 2 (a) of the Act of December 17, 1943, c. 346, 57 Stat. 601] *General Rule.*—Interest upon the amount determined as a deficiency shall be assessed at the same time as the deficiency, shall be paid upon notice and demand from the collector, and shall be collected as a part of the tax, at the rate of 6 per centum per annum from the date prescribed for the payment of the tax (or, if the tax is paid in installments, from the date prescribed for the payment of the first installment) to the date the deficiency is assessed, * * *.

* * * * *

(26 U.S.C. 1946 ed., Sec. 292.)

SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

* * * * *

(b) *Fraud.*—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall

be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612 (d) (2).

(26 U.S.C. 1946 ed., Sec. 293.)

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